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ECONOMIC VIEW

When 'Deficit' Isn't a Dirty Word

By ROBERT H. FRANK

ARE you confused about whether large federal budget deficits matter?

No wonder, when disagreement about deficits is popping up everywhere. Even among Republicans, there is no unity on this basic issue. Defending his recent proposal to freeze government spending, Representative John A. Boehner, the House minority leader, said, "We simply cannot afford to mortgage our children and grandchildren's future to pay for this big government spending spree." But Martin Feldstein, the Harvard economist, disagrees. An adviser to the past three Republican presidents, Professor Feldstein warns that failure to run large deficits would prolong the current economic downturn.

Because important policy decisions hinge on whether deficits matter, this is an opportune moment to take stock of what we know. The good news is that there is little disagreement among economists who have studied the issue. The consensus is that short-run deficits help end recessions, and that whether long-run deficits matter depends entirely on how government spends the borrowed money. If failure to borrow meant forgoing productive investments, bigger long-run deficits would actually be better than smaller ones.

In 1929, President Herbert Hoover thought that the best response to a collapsing economy was to balance the federal budget. With incomes and tax receipts falling sharply, that meant cutting federal spending. But as almost all economists now recognize, President Hoover was profoundly mistaken.

When a downturn throws people out of work, they spend less, causing still others to be thrown out of work, and so on, in a downward spiral. Failure to use short-run deficits to stimulate spending amplifies that spiral, causing further declines in tax receipts and even bigger deficits. That this path makes no sense is a settled issue.

But what about long-run deficits? To think more clearly about them, we must recognize that carrying debt is costly. The government can pay just the interest on its debt each year, or it can pay interest plus some additional amount to reduce the principal. The yearly payment is clearly greater in the second case, just as a homeowner's monthly payment is larger with a 10-year mortgage than with a 30-year one. But the total burden of the various repayment options (in technical terms, their "present value") is exactly the same. It's a simple trade-off between intensity of burden and duration of burden.

No matter which option we choose, money spent to service debt can't be spent for other things we value. But that doesn't mean we should always borrow less. The main issue is what we do with the borrowed money.

If we simply use the money to buy bigger houses and cars, deficits make us unambiguously worse off in the long run. That's why the explosive increase in the national debt during the Bush administration was a grave misstep.

Trillions of dollars, many of them borrowed from China, financed tax cuts for the wealthy, who spent much of their added wealth on things like bigger mansions. But beyond a certain point, when everyone builds bigger, the primary effect is merely to raise the bar that defines the size of home that people feel they need. Much of the interest we'll pay on debt incurred during the Bush years is thus money down the drain.

In contrast, borrowing for well-chosen investments doesn't make us poorer. Road maintenance is a case in point. Failure to repair roads in a timely way could mean eventually spending two to four times as much for the work. Even ignoring the fact that timely repairs would reduce the substantial vehicle damage from potholes, it would be much cheaper to borrow the money and do maintenance on schedule.

It's also useful to put the nation's debt burden into perspective. Over the last eight years, Bush administration deficits raised the national debt by almost $5 trillion. Given the current crisis, it's easy to imagine a similar increase during the next four years. At recent interest rates, servicing $10 trillion of extra debt costs about $400 billion annually — a big amount, to be sure, but less than 3 percent of the economy's full-employment output. We'll still be the richest country on the planet even after paying all that interest.

Once the downturn ends, there should be no need to incur additional debt. Indeed, there are many ways to pay down debt without requiring painful sacrifices. A $2 tax on each gallon of gasoline, for example, would generate more than $100 billion in additional revenue a year. Europeans, who pay more than $2 a gallon in gasoline taxes, have adapted by choosing more efficient cars — and they appear no less satisfied with them.

We could also levy a progressive consumption surtax, which would not only generate additional revenue to pay down debt or finance additional public investment, but would also stimulate private savings by diverting money from those over-the-top coming-of-age parties that the wealthy stage for their children.

Notwithstanding the neo-Hooverite talk from stimulus-program opponents, the current deficit isn't too large. If anything, it may need to be even larger to revive the economy. In the long run, new sources of tax revenue could keep deficits from growing and could even pay down existing debt. But if the political system cannot figure out how to pay for productive investments with tax revenue, we'd still end up richer, on balance, by making those investments with borrowed money.

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